UNION OIL CO.
UNION EXPLORATION PARTNERS, LTD.

IBLA 88-12, 89-108 Decided November 7, 1989

Appeals from decisions of the Director, Minerals Management Service, affirming assessment of additional royalty and assessing late payment charges. MMS-87-0507-OCS and MMS 86-0186-O&G.

Set aside and remanded.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Royalties: Payments--Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where a floor price was established generally for natural gas liquid product valuation for royalty calculation, royalty could not be assessed using a higher rate than the floor price.

2. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Royalties: Payments--Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where royalty payments made by an oil and gas lessee were based on values lower than values for actual sales of the products in question, assessment for underpaid royalty was properly made.

3. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Royalties: Payments--Outer Continental Shelf Lands Act: Oil and Gas Leases

   It was premature to assess late payment charges while the principal amount of royalty owed by a lessee remained to be determined on appeal and where the requirement to pay pending appeal was stayed until final decision concerning the principal amount owed could be issued.

APPEARANCES: Matthew Kepner Brown, Esq., Deborah Bahn Price, Esq., and J. Berry St. John, Jr., Esq., New Orleans, Louisiana, for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., and Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Union Oil Company of California and Union Exploration Partners, Ltd. (collectively, Union), have appealed from a decision of the Director, Minerals Management Service (MMS) (MMS-86-0186-O&G), dated August 13, 1987, requiring payment of $229,075.95 additional royalty on natural gas liquid products (NGLP) produced from Federal oil and gas leases on the Outer Continental Shelf and processed at the North Terrebonne Gas Processing Plant and Tebone Fractionator (Terrebonne) in Terrebonne Parish, Louisiana. Union has also appealed from a decision, MMS-87-0507-OCS, dated August 31, 1988, affirming the imposition of charges for late payment of this additional royalty. At the request of the parties, both appeals are consolidated for decision.

Much of Union's Terrebonne NGLP production was not marketed but was used internally and valued for Federal royalty purposes at intracompany transfer prices. The Office of Inspector General (OIG) audited Terrebonne's royalty accounts for the period from January 1977 through December 1983. In a final audit report issued June 1985, OIG reported additional royalties were due from Union for the period from January 1980 through December 1983. The OIG report concluded that because Union had undervalued NGLP, primarily butanes subject to intracompany transfers, it had underpaid royalties on NGLP by $53,085.13. The OIG also identified $175,990.82 in additional royalties due because invoice prices for sales of processed substances exceeded prices reported by Union to the Department for purposes of royalty payment.

To reach the conclusions stated concerning intracompany transfer prices, OIG relied on valuation methodology outlined in a MMS "Procedure Paper on Natural Gas Liquid Products Valuation" issued by MMS Royalty Valuation Standards and Royalty Compliance Division on December 14, 1984, as revised February 25, 1985 (Procedure Paper). The OIG report recommended that MMS recalculate Union's manufacturing allowances, assess additional royalty, and assess interest and penalties accordingly (Final Audit Report at 8, 12).

On March 4, 1986, MMS, acting in response to the OIG report, directed Union to pay additional royalties of $229,075.95 on NGLP processed at Terrebonne from January 1980 through December 1983. Union appealed this determination to the Director, MMS, who, on August 13, 1987, approved assessment of additional royalties as previously ordered. The Director found that such assessment might properly be made, although Union's manufacturing allowances for NGLP had not yet been calculated by MMS, because establishment of NGLP value would aid later allowance calculation.

In his decision at page 7, the Director observed that NGLP valuation was a necessary first step towards establishing a manufacturing allowance. Approving the prior order, the Director found that use of reported intracompany transfers which were lower than spot market prices had resulted in underpayment of royalties in the amount of $53,085.13 (Decision at 3). He also found that, in certain arm's-length transactions with other companies, Union had reported prices for royalty payment purposes that were lower than

invoice prices for those sales and that additional royalties of $175,990.82 were owing as a result. Id.

Union characterizes the issues raised by this appeal as concerning both "due process challenges" and "substantive challenges" (Reply at 1-2). In the latter category, Union's statement of reasons for appeal (SOR) explains, are questions about "(1) the incorrectness of the NGLP values used in the audit and (2) the need to delay resolution of the valuation issue until the MMS' audit for the period is complete" (SOR at 2). In reaching the former question, it is the use of the Procedure Paper to determine NGLP values which most concerns Union. 1/

Concerning the Procedure Paper's use by MMS, Union contends that MMS failed to follow the paper when it valued Union's NGLP, and that the royalty valuation approved by the Director was incorrect as a result. It is apparent that the Director, having determined that Union's intracompany transfer prices fell below spot market prices, refused to accept Union's valuations for royalty purposes and imposed a value derived by averaging the high and low spot market prices for questioned values. MMS defends this practice, required by the Procedure Paper, by explaining that, under the paper,

> [p]rices that fall below the lowest spot market price are considered unreasonable and less than the fair market value while those within the range of the lowest and highest spot prices are reasonable and at a fair market value. The regulations and lease give the Director authority to establish fair market value and when the price reported for royalty purposes falls below this threshold it is certainly reasonable to establish the royalty value based on the average spot price.

(MMS Answer at 8).

This response establishes that the Director did, as was indicated in his decision dated August 13, 1987, average the high and low spot market prices to arrive at a valuation for Union's NGLP. Because he did so, the valuation derived was incorrect, as Union contends, and this matter must be remanded to permit a proper calculation of value to be made.

1/ In an argument characterized by the SOR as "the geographical problem," Union urges that a transportation allowance should be granted by MMS to equalize a perceived difference between prices at the Terrebonne plant and at Mont Belvieu, the origin of the spot market prices used by MMS to calculate average prices for underpaid intracompany transfers. A difference between Terrebonne and Mont Belvieu prices is assumed for this argument, but is not shown to exist. Nor is any legal authority cited for the proposition that a transportation allowance should be granted for such a difference. The record indicates that Terrebonne and Mont Belvieu are separated by more than 200 miles distance, but does not show how this separation results in different prices in the two places.

[1] In our recent decision in Conoco, Inc., 110 IBLA 232 (1989), we considered use by MMS of the Procedure Paper to value NGLP. Concluding that use of the paper was not fundamentally unlawful, we nonetheless found that the averaging procedure required by the paper when a lessee's royalty valuations were lower than posted market prices could not be approved. Therein, we explained that

> the lowest posted spot market price of the month establishes a floor for royalty valuation. * * * a price falling below the floor value is raised not to the floor value, but to a price computed by averaging the floor value with the high spot market price, in effect making the average the floor value. We find that the acceptance of any settlement price within the range of the low to the high spot market price as constituting fair market value is inconsistent with requiring payment of the average spot market price where lessee's settlement price is less than the floor value. * * * If the average spot market price rather than the floor price constituted fair market value, then MMS would be without authority * * * to accept royalty settlement prices as low as the floor price.

Id. at 244.

Union has directed a hypothetical argument to this aspect of the Procedure Paper, postulating a situation where price averaging, which sets valuation at a price above the floor price, subjects different royalty payors to different standards and may, in practice, cause lessees who have made simi-lar payments to be subject to vastly dissimilar treatment by MMS (SOR at 7-10). It was a similar consideration which led us, in Conoco, Inc., supra, to disapprove the price averaging provision of the Procedure Paper for pur-poses of royalty valuation. Accordingly, so much of the Director's decision as relied on averaging of high and low spot market prices to value Union's intracompany transfer production is set aside. Consequently, the conclusion that Union had underpaid royalties by $53,085.13, reached by averaging, must be re-examined on remand and the floor price properly applied. Conoco, Inc., supra.

[2] Not all the Director's findings that additional royalty must be paid by Union depended upon averaging of spot market prices, however. The $175,990.82 assessment depended upon his finding that some prices reported for purposes of royalty valuation were less than actual invoice prices for sale of those same processed products. This indicated, and the Director found, that Union's royalty payments for the products concerned was less than the gross proceeds Union had received from the sales of the products. See 30 CFR 206.150, providing that value of production may never be less than gross proceeds.

MMS had previously ordered Union to value NGLP sales made in arm's-length transactions at the actual price received for such transactions. Union has disputed neither the order that such payments should be made nor that the valuation method required by MMS was proper.

Nor has Union argued this issue on appeal. While Union appealed generally from the Director's decision assessing additional royalties, charging that the valuations used by the Director were "incorrect," the reason underlying this allegation is not explained so far as concerns the finding that Union had underpaid $175,990.82 because it used lower values than were shown on the relevant sales invoices. Conclusory allegations of error do not alone suffice to point out error, and an appeal supported only by such allegations must fail. United States v. Fletcher De Fisher, 92 IBLA 226 (1986). We therefore affirm that part of the Director's decision providing for assessment of additional royalty resulting from underreported arm's-length sales. Nonetheless, as was the case with the underpaid intracompany transfer payments considered above, the amount of manufacturing allowance deductible from this amount remains to be computed. It is undisputed that this allowance has not been calculated by MMS for the account here under review. Consequently, we must consider whether the principal amount of underpayment owing by Union has been determined by MMS, so as to permit determination of late charges.

[3] By letter dated December 22, 1987, MMS granted Union a stay of the requirement that the underpaid royalties claimed to be owed in this case be paid pending appeal. Referring to our decision in Marathon Oil Co., 90 IBLA 236, 93 I.D. 6 (1986), the Associate Director for Royalty Management ordered that MMS "stay the requirement to pay pending appeal until the Department of the Interior makes a final decision on the merits of [Union's] appeal, provided [Union] posts a bond in accordance with 30 CFR | 243.2 (1986)." The required bond was posted. In a memorandum dated May 5, 1988, the Area Manager, Houston Compliance Office, then recommended that: "Since the determination of the North Terrebonne audit findings designated as MMS-86-0186-O&G currently under appeal to the IBLA will also determine the result of this appeal for the associated late charges, we recommend that the late payment assessment designated as MMS-87-0507-[OCS] be consolidated with Union's appeal MMS-86-0186-O&G."

This recommendation apparently provided the foundation for the decision dated August 31, 1988, which assessed late payment charges against Union. That opinion reasons that assessment of late charges was appropriate notwithstanding that it had not yet been finally determined what principal amount of royalty was owed by Union, because: "Unless and until administratively or judicially modified or reversed, the assessment of the deficiency concerning the royalty value of the NGLP's will be deemed to have been correct. Thus the imposition of the late payment charges was not premature" (Decision at 3).

In response to Union's arguments that late payment charges should not have been assessed because "the underlying assessment on which the late payment charges are based is the subject of a pending appeal," and also because "the audit is not yet complete" and in seeming contradiction to this Board's decision in Marathon, supra, MMS has responded that "MMS regrets any confu-sion that may have been caused by its decision [to assess late charges].
Additionally, in lieu of payment, * * * a bond has been approved through December 31, 1989" (Motion to Consolidate and Answer at 1).

Union correctly points out that, concerning assessment of late payment charges pending appeal, Marathon Oil Co., supra, addressed a situation where MMS ordered assessment of late charges while the question of the principal amount of royalty owed remained undecided pending appeal. In Marathon, we pointed out that there was a good reason not to permit such a procedure because in such a situation the oil and gas lessee is "threatened with the irreparable injury of lost interest on the funds ordered to be paid since there is no authority for payment of interest to the lessee on any royalty payments ultimately determined to constitute an overpayment." Id. at 247, 93 I.D. at 12. The same situation is apparent here.

Union contends MMS has yet to finish calculating the final amount of royalty due in accordance with Departmental regulations authorizing manufacturing allowances. We cannot determine the question of late charges on the record before us, Union argues, because failure by MMS to compute the manufacturing allowance provided by 30 CFR 206.106 and 206.152 makes a decision concerning late payment charges a practical impossibility until the principal amount owed has been decided. Union reasons that:

> The validity of the MMS's royalty assessment cannot be determined without reference to processing costs. Any attempt to do so ignores the practical aspects of valuation and assumes that value can be derived properly from an abstract standard that is totally unrelated to the leases in question. This is simply not the case. Unions's assessment of value is directly related to processing and manufacturing costs.

(SOR at 10).

The NGLP produced by Union for which royalties were paid are manufactured substances. For such substances an allowance is contemplated by Departmental regulation providing pertinently that:

> A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required.

30 CFR 206.106. The extent of the allowance to be granted is to be "determined by the Director and based upon actual plant cost and other pertinent factors." 30 CFR 206.152. The allowance so calculated may then "be
deducted from the royalty payment due on said constituent substances." Id. The allowance shall not exceed two-thirds of NGLP value. Id.

Furthermore, the OIG report, on which the Director's decision under review relies for the principal findings made concerning deficient royalty

payments, recommended, concerning manufacturing allowances to be established for Union's Terrebonne production, that MMS should:

> 1. Recalculate North Terrebonne's manufacturing allowances for the biennial periods covered by this examination.
>
> 2. Require North Terrebonne's owners to recompute and pay additional royalties on NGLPs using the revised manufacturing allowances.
>
> 3. Assess interest and penalties on additional royalties due the Government, where applicable.

(Report at 12).

This recommendation by OIG was not followed by MMS. Instead, the value of NGLP was calculated, incorrectly in the case of intracompany transfers, and a payment order issued before a manufacturing allowance was computed for Union. Because MMS used an erroneous method for calculating the additional royalty due on intracompany transfers of NGLP, the principal amount of royalty owing for this account item remains to be calculated. Additionally, under provision of 30 CFR 206.106 and 206.152, Union is entitled to an allowance for royalty purposes before this principal amount is determined.

Similarly, in the case of the arm's-length transactions for which MMS correctly determined the principal amount owing, no allowance has been computed, so that the record before us contains no foundation for a finding that the interest charge assessed by MMS for late payment of this assessment was correctly calculated. It is undisputed, as Union contends, that an allowance for manufacturing is properly claimed for both categories of underpaid royalty before us, because all royalties were paid on liquid hydrocarbon substances produced at Union's Terrebonne plant.

The order of procedure in which OIG stated recommendations for determination of Union's royalties reflects the order of administration contemplated by 30 CFR 206.106 and 206.152. While, as the Director observed, it was necessary to final disposition of this audit to decide the value of NGLP for royalty purposes, the failure to also calculate the manufacturing allowance leaves the computation incomplete. On remand, MMS must compute the manufacturing allowance due Union before calculating the amount of interest owed for late payments made on this account. See 30 CFR 206.106 and 206.152.

We therefore conclude that the amount of underpaid royalties found by the Director to be owing by use of an incorrect price for averaging formula for intracompany transfers was erroneously calculated to be $53,085.13. This amount must be recalculated using the spot market floor price in the manner explained by our decision in Conoco, Inc., supra. The Director's

determination that additional royalty payment was due for understated arm's-length sales prices is affirmed. 2/ This case is remanded, however, to permit the calculation of a reasonable allowance for the cost of processing NGLP for which royalties are being assessed herein, which allowance, if any, shall be deducted from the royalty payments found to be due, subject to the proviso of 30 CFR 206.152 establishing a limit on such allowances.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions by the Director, MMS, are set aside and remanded for action consistent with this opinion.

Franklin D. Arness
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge

2/ Other arguments raised by Union but not discussed in this decision have been considered and rejected.